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STATE PLEASE PASS TO USTR FOR SCRONIN
DEPT OF TREASURY FOR SSEGAL
USDOC FOR 4332/ITA/MAC/WH/OLAC/SHIELDS
USDOC ALSO FOR 3134/ITA/USCS/OIO/WH/RD/CREATORE
USDA FOR FAS/ITP AND FAS/FAA/WH
STATE PASS OPIC FOR MORONESE, RIVERA, MERVENNE
STATE PASS EXIM FOR NATALIE WEISS, COCONNER
STATE PASS USTDA FOR AMCKINNEY

E.O. 12958: N/A
TAGS: EINV EWWT ETRD BR
SUBJECT: GOB Focuses on Key Projects to Help Close Infrastructure Deficit

REF: A) Brasilia 1087, B) Rio de Janeiro 1291

¶1. (SBU) Summary and Introduction. With exports rapidly increasing, Brazil's transportation infrastructure is bursting at the seams. The country's inefficient (and insufficient) ports, its deficient roads, and its decrepit rail network serve as bottlenecks to the timely dispatch of commercial cargo. Well aware that past shortfalls in infrastructure investment are now resulting in greater costs and lost export opportunities, the GOB is now looking at how it can quickly expand its transport capacity. Of the four road/port/rail projects at the top of the list, the GOB is currently contemplating moving forward with three of them through its planned public private partnership (PPP) regime. Delays in the passage of the PPP legislation through congress have meant that these three projects could - at the earliest - only be opened for bidding by mid-2005. The GOB also needs to decide how to account for potential liabilities arising from public sector PPP guarantees. Notwithstanding Planning Ministry predictions of passage of the legislation within 30 days, this time-line is even further lengthened if congress continues to dawdle. The export crops most affected by this infrastructure deficit are high-volume, low-margin bulk grains such as soybeans - the star performers in Brazil's current export boom. End Summary and Introduction.

¶2. (U) With the Brazilian real competitively priced in the range of 2.8 - 3.2 to one USD, this year Brazil has been enjoying an export boom. Exports, which the Ministry of Development, Industry, and Commerce had hoped would reach the USD 80 billion figure this calendar year, are now on track to reach over USD 90 billion. Exports have increased across all categories, including primary, semi-manufactured and manufactured goods, although basic commodities (such as soybeans) have proven to be the star performers. Meanwhile, earlier GOB estimates of a 2004 trade balance of a USD 23 billion, have now been adjusted upwards to USD 32 billion.

¶3. (U) Inadequate investment in public infrastructure, however, has left Brazil's transport infrastructure in a precarious state. First, the relative lack of development of inland waterway transport in Brazil means that most of the country's export grains must move to port via truck, which comes out to about 3 times the cost of barge transport. Second, three-quarters of Brazil's paved roads have deteriorating pavement, inadequate signs or access roads, or are improperly graded. The country's railroads are in a similar state of disrepair, and bottlenecks at the country's principal maritime dispatch point - the Port of Santos - continue unabated. Indeed, exporters of high-value items have resorted to expensive air-freight to transport their goods to foreign markets. GOB figures show that in August 2004, the number of exports sent by air increased 9.2 percent over the year before. Manufacturers are relying upon air transport to send items such as auto parts, cellular phone parts, and even cuts of beef.

¶4. (SBU) Ministry of Planning officials lament the country's lagging commitment over the past two decades to infrastructure investment. The challenge, according to the Ministry's International Affairs Chief, Jose Carlos Miranda, is to reconcile the GOB's desire to expand public investment (to generate greater growth) with its desire to maintain a primary fiscal surplus (to maintain the confidence of the markets). To resolve this dilemma, Miranda observed that the GOB has taken a pragmatic approach: it will allocate budget monies to pressing public sector projects, it will encourage the private sector to move forward in cases where a project can be undertaken on a commercial basis, and through its public-

private partnership program it will promote development of those projects that the private sector would not undertake without some form of public assistance.

¶5. (SBU) Translating theory into practice, however, has proven difficult. Though the Railroad Revitalization Plan launched by the GOB in 2003 has sought to prioritize rail improvements, of the USD 20 million budgeted for this purpose this year only $15 million has been spent - a fraction of the amount needed to do the job. The real engine responsible for the rail improvements the country has made has been the private sector, specifically the steel/mining conglomerates CVRD and CSN. According to the leading daily "O Estado de Sao Paulo," nearly all of the USD 360 million that was invested in rail in 2003 and the USD 285 million spent during the first half of 2004 originated from the private sector. By improving rail lines from their inland plants to the northern port of Itaqui (near Sao Luis in Maranhao state), CVRD and CSN hope to cut their transport costs significantly. CVRD also has been responsible for the rehabilitation of the rail line connecting the Center-West and Minas Gerais with the burgeoning Port of Vitoria in Espirito Santo; the rail line is considered the cheapest, most modern, and most productive rail line and carries products such as steel, coal, and iron ore. Meanwhile, concessions for private-sector road construction and maintenance in Brazil have largely been successful over the past 5 to 6 years, bringing significant improvements in road quality to the South and Southeast.

¶6. (SBU) Much the same story is true for the urgent USD 207 million project to widen and pave BR-163, the 1,760 kilometer highway linking Cuiaba in Mato Grosso state to the Amazon river port of Santarem. Paving the current dirt (or when it rains, mud) sections of that highway, will allow soybean producers to export their 15.0 million ton crop north to the coast via the Amazon - as opposed to south via the Sao Paulo state port of Santos or the Parana port of Paranagua. Estimates are that this northern route will cut USD 12 per ton in freight costs, a significant amount for a high-volume, low margin crop like soybeans. (By way of comparison, on average Brazil's soy farmers spend about USD 34 a ton on freight costs from many inland areas - about twice the amount spent by Argentine and U.S. producers.) Miranda noted that the private sector (i.e., soy farmers) was the primary moving force behind implementation of this project, partly because of the gains they would make and partly because concerns about damaging the Amazon environment made it an issue difficult for the GOB to tackle. The GOB is looking at the issue of sustainable development and its impact on the rate of deforestation along the proposed road very closely.

¶7. (SBU) Miranda saw PPPs as key where the private sector return on a project did not match the public sector benefits, i.e. - the positive externalities for the country as a whole were not considered. Once the Senate passed the PPP legislation currently pending in Congress (and the Chamber of Deputies signed on to the Senate's changes), the PPP process would be ready to go. Three projects that the Ministry thought would bring the most bang for the buck were queued up for quick approval, he said: a) USD 170 million in rail/road improvements to speed entry to the Port of Santos, b) USD 33 million in similar improvements to the Port of Sepetieba in Rio State, and c) USD 160 million in rail construction to complement ongoing efforts on the feeder routes into Itaqui (along with the expansion of the Itaqui port itself, costing approximately USD 55 million). The GOB envisioned 50 to 60 percent private sector participation in these projects, with the remainder of the work to be done by the GOB itself. More projects were on the drawing board, Miranda said, but these would have to wait for a second wave.

¶8. (SBU) Miranda optimistically predicted that the PPP bill would be finalized soon after the second round of the municipal elections (October 31), and indeed Senate hearings on the draft legislation were set to resume the week of October 11. However, Ministry of Planning Economic Advisor Damian Fiocca noted that given the need to issue regulations and set up an agency to run the PPP program, once the legislation was approved it would be six months - at a minimum - before the first project could move forward.

¶9. (U) Currently, negotiations are proceeding on the bill in the Senate, principally regarding how to account for any payments made by the GOB to concession operators in the out-years. This issue is key given the potential for state guarantees to PPP projects to become large unaccounted liabilities. According to the IMF Resident Representative (ResRep), the Ministry of Finance is convinced that the Fiscal Responsibility Law gives it the authority to enforce appropriate accounting of the government's liabilities at both the state and the federal level. Unfortunately, no satisfactory standard to account for these PPP risks

exists. In the absence of an agreed standard, the IMF has proposed, according to the ResRep, that the federal and state budgets explicitly list all expected fiscal flows related to PPPs and the expected value of guarantees given to PPPs. This would be an interim measure until such time as an accounting standard could be agreed to. To date, however, Ministry of Finance has not yet ruled definitively on the accounting issue.

¶10. (SBU) Ministry of Planning officials note that in the end the bill will reflect a compromise between those in the GOB who would prefer that the government be responsible for investment in transportation infrastructure and those who see the need for a large private sector role. Assuming that the bill passes, this struggle could prove to be an ongoing one as the two poles seek to have their point of view reflected in the make-up of the PPP agency, the eventual implementing regulations, and the design of the follow-on projects.

¶11. (SBU) Comment. Whether the final version of the PPP program will offer interested private sector investors sufficient guarantees is an open question. Given congressional opposition to providing PPP investors precedence over existing debt obligations, the GOB may have to resort to a guarantee fund to reassure participants that sufficient funds will be forthcoming for out-year payments. Some economic analysts here question whether all the internal to and fro on this issue within the Lula Administration and the governing coalition will prove to be worth the effort, noting that perhaps the time and political capital devoted to this could have been spent more wisely encouraging investment through the existing concession/licitation process. Greater GOB attention to the basics - like reducing bureaucratic red tape, increasing the reliability of the judicial system, and better defining the regulatory rules of the road - likely would do the most, in the least amount of time, to promote greater investment.

Danilovich